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SECOND CIRCUIT DECISION IN TOWER RESEARCH CAPITAL ON  
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## ASK THE PROFESSOR—WHAT IS THE IMPACT OF THE RECENT SECOND CIRCUIT DECISION IN TOWER RESEARCH CAPITAL ON THE GLOBAL FUTURES MARKETS?

by Professor Ronald Filler

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### INTRODUCTION

In a highly controversial and unusual opinion, Judge Kimba Wood, writing for the Second Circuit, held in *Tower Research Capital* that the matching of trades at night on the CME Globex platform of the KOSPI 200 Futures Contracts traded on the Korean Exchange (“KRX”) gives five Korean traders the right to bring a “spoofing” allegation against Tower Research Capital (“Tower”), a hedge fund.<sup>1</sup> The opinion noted that Tower traded 4,000,000 trades of the KOSPI contract on Globex in 2012, which represented approximately 54% of the market share, whereas these five Korean traders traded 1,000 such contracts in 2012.<sup>2</sup> All of the trades at issue were deemed to be “night trades.” For the KOSPI contract, even though it is cleared at KRX, the CME agreed to allow KRX to use its CME Globex platform to execute and “match” these night trades as the KRX did not offer any such night trading platforms. The federal district court in this case issued two decisions,<sup>3</sup> both of which denied the Plaintiffs’ claims, citing *Morrison*.<sup>4</sup>



The allegations brought by the Plaintiffs involve “spoofing” by the Defendants as their large market share and high frequency trading allegedly caused injury to the Plaintiffs.<sup>5</sup> Even though the Plaintiffs could not prove that the Defendants were on the opposite side of any of their KOSPI orders placed via Globex, they argued that, given the fact that the Defendants placed 4,000,000 orders on Globex in 2012, statistically, one or more of the Plaintiffs’ orders had to be matched by the Defendants.

In *Morrison*, the U.S. Supreme Court denied that Section 10b of the Securities Exchange Act of 1934, 15 U.S.C.A. 78j(b), or SEC Rule 10b-5, applied to extraterritorial securities transactions unless it can be proven that such transactions (1) were listed on a domestic exchange, or (2) were domestic transactions in other securities.<sup>6</sup> *Morrison* was strictly a securities case and did not involve the Commodity Exchange Act (“CEA”), 7 U.S.C.A. 1 et seq., or any regulation promulgated by the Commodity Futures Trading Commission (“CFTC”). The federal district court in this case, citing *Morrison*, reasoned that the Defendants’ alleged conduct was within the territorial reach of the CEA only if these KOSPI contracts were purchased or sold in the United States or were listed on a domestic exchange.<sup>7</sup> The district court noted that these KOSPI orders were placed in Korea, and not in the U.S., and the fact that they were merely matched on Globex, which is located in Illinois, were final only when cleared the next day in South Korea.<sup>8</sup> The district court then held that, while the CME is a domestic exchange, its Globex platform is not.<sup>9</sup> Therefore, no trading took place on a “domestic” exchange.

## **MORRISON ANALOGY**

The Second Circuit took issue on a number of points set forth in the district court’s two opinions and reversed and remanded them back to the district court. The first point was that *Morrison* did not apply to the CEA or to futures contracts.<sup>10</sup> It did cite another Second Circuit decision, *Loginovskaya*<sup>11</sup>, that applied *Morrison* to the CEA but distinguished *Loginovskaya* on the grounds that it did not involve a trade on a futures domestic exchange.<sup>12</sup> The Court focused on another case, *Absolute Activist*,<sup>13</sup> that it held did apply to a case involving the CEA.<sup>14</sup> In *Absolute Activist*, the Second Circuit concluded that a transaction involving securities is a “domestic transaction” under *Morrison* if “irrevocable liability is incurred or title passes within the United States.”<sup>15</sup> This “irrevocable liability” test proved to be the main reason why the Second Circuit reversed the lower court’s decisions.

The Second Circuit stated:

“Irrevocable liability attaches ‘when the parties to the transaction are committed to one another’ or ‘in the classic contractual sense, there is a meeting of the minds of the parties.’”<sup>16</sup>

The Court then held that there is a plausible possibility that, when these night trades in the KOSPI contract are matched here in the U.S., the parties might incur irrevocable liability.<sup>17</sup> Since this was sufficient to resolve the extraterritorial jurisdictional issue, the Court chose not to consider whether Globex was a domestic exchange.<sup>18</sup>

The key analysis by the Second Circuit was its refusal to apply *Morrison* to the CEA. It stated:

“. . . the district court and the parties seemed to assume that *Morrison*’s ‘domestic exchange’ prong applies to the CEA either to broaden or to narrow its extraterritorial reach.”<sup>19</sup>

It then noted:

“The section of the CEA relevant to a territorial analysis . . . does not contain the language similar to the language in § 10(b) that led *Morrison* to craft the ‘domestic exchange’ prong.”<sup>20</sup>

“Plainly, the reasoning of *Morrison* does not preclude the application of the CEA to trades made on a foreign exchange when irrevocable liability is incurred in the United States.”<sup>21</sup>

The Second Circuit then held that, even though the trades would be cleared in Korea, there was the plausibility that such irrevocable liability could result from the matching of the orders on Globex as the CME claims that matched orders are “binding contracts.”<sup>22</sup> It then held that there are two transactions, namely the matching of the orders on Globex and the clearing of the orders on KRX, that apply here.<sup>23</sup>

## **ANALYSIS OF THIS OPINION**

The Second’s Circuit complete focus on one aspect of *Morrison* ignores the method as to how the global futures markets are traded. The futures markets are indeed global. Foreign boards of trades have been given exemptions from the CFTC for many years to allow its terminals to be placed here in the U.S. without first being required to register as a “domestic contract exchange.”<sup>24</sup> Similarly, U.S. futures exchanges are allowed to place their terminals abroad. Orders are merely matched via these terminals. I am not aware that any other case has ever formed the basis for any action against any defendant on an exchange terminal. Query, does the mere matching of orders on these terminals actually create the irrevocable liability that the Second Circuit has stated? I do not think so. A futures contract must be both executed and cleared, in my opinion, to be irrevocable.<sup>25</sup> In *Tower Re-*

*search Capital*, the clearing component clearly took place outside the U.S. Query, in order to invoke jurisdiction under the CEA, shouldn’t both functions take place in the U.S.? Moreover, there is no liability imposed on Globex or on any brokerage firm that provides any of these terminals to their customers unless the customer can prove “gross negligence.” Maintaining a large market share, as what was alleged in this case by the Plaintiffs, does not, on its face, prove this higher standard of liability.

Therefore, how will such irrevocable liability ever be proven. If these Plaintiffs, or others who may become part of a proposed class action, were harmed in any way by the Defendants, then let them bring an action in South Korea.

Moreover, CEA Section 4b(d) specifically states that the anti-fraud provision of the CEA does not apply to “any activity that occurs on a board of trade, exchange or clearinghouse . . . located outside the United States . . . involving any contract of sale of a commodity for future delivery . . .”<sup>26</sup> Section 4c(a)(5) of the CEA, which was added by the Dodd-Frank Act in July 2010, further states that the “disruptive practices” section only applies to “any trading, practice, or conduct on or subject to the rules of a *registered entity* . . .”<sup>27</sup> It appears that the Second Circuit completely ignored these two important sections of the CEA. As noted above, it did not address the issue as to whether CME Globex was or was not registered with the CFTC, which the federal district court noted that it was not so registered.

Finally, the Second Circuit also completely ignored Section 22(a)(1)(D) of the CEA, which clearly only authorizes a private right of action for actual damages against persons that employ

“any manipulative device . . . in connection with . . . a commodity . . . for future delivery on or subject to the rules of any registered entity.”<sup>28</sup>

This CEA section does not authorize any private rights of actions regarding any “spoofing” allegation under Section 4c(a)(5) and only applies to any manipulative behavior under Section 6(c)(1) of the CEA.<sup>29</sup>The Plaintiffs in *Tower Research Capital* are seeking monetary damages that allegedly resulted from “spoofing” actions taken by the Defendants in that case. There is thus no express private right of action under Section 22 of the CEA for the Plaintiffs in *Tower Research Capital* to allege as the trades did not take place on a registered entity. Moreover, arguably, there is no implied private right of action either.

## CONCLUSION

The District Court on remand in analyzing the merits of this case should find that there was no irrevocable liability by the Defendants, based on what was noted above but also on my belief that “spoofing” is an unconstitutionally vague term.<sup>30</sup> Moreover, the federal district court needs to address the other legal issues noted herein involving Sections 4b, 4c(5), 6(c)(1) and 22(a)(1)(D) of the CEA. Presumably, this case against Tower Research Capital will be dismissed once again.

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## ENDNOTES:

<sup>1</sup>*Myun-Uk Choi et al v. Tower Research Capital LLC et al.*, No. 17-648-cv (2d Cir., March 29, 2018). The Second Circuit decision was an appeal from a Motion to Dismiss at the federal district court level.

<sup>2</sup>Please note that these 4,000,000 contracts represented actual fills whereas most “spoofing”

cases imply that orders are not executed but are cancelled before any such execution.

<sup>3</sup>*Myun-Uk Choi et al. v. Tower Research Capital, Ltd. et al*, 165 F. Supp. 3d 42 (S.D.N.Y. 2016) and 232 F. Supp. 3d 337 (S.D.N.Y. 2017), Docket No. 14-cv- 09912.

<sup>4</sup>*Morrison v. National Australia Bank, Ltd.*, 561 U.S. 247 (2010). Morrison was decided two months before the enactment of the Dodd-Frank Act. See also, Ronald H. Filler & Jerry W. Markham, REGULATION OF DERIVATIVE FINANCIAL INSTRUMENTS (SWAPS, OPTIONS, AND FUTURES) CASES AND MATERIALS, Chapter 12 (2014) (describing the *Morrison* case) (hereinafter “Filler & Markham”).

<sup>5</sup>See Amicus Brief filed with the U.S. Supreme Court in *United States v. Michael Coscia*, Docket No. 17-1099, which I co-authored along with Professor Jerry Markham.

<sup>6</sup>*Id.* at 267.

<sup>7</sup>See the first of the two cases cited in Note 2, *supra*, at 48.

<sup>8</sup>*Id.* at 49.

<sup>9</sup>*Id.*

<sup>10</sup>Slip Opinion, at 11.

<sup>11</sup>*Loginovskaya v. Batratchenko.*, 764 F. 3d 266, 272-275 (2d Cir. 2014)

<sup>12</sup>Slip Opinion at 11.

<sup>13</sup>*Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F. 3d 60 (2d. Cir. 2012)

<sup>14</sup>Slip Opinion at 12.

<sup>15</sup>*Id.*

<sup>16</sup>*Id.* See also Note 11, *supra*, at 68.

<sup>17</sup>Slip Opinion at 13.

<sup>18</sup>*Id.*

<sup>19</sup>Slip Opinion at 14.

<sup>20</sup>*Id.*

<sup>21</sup>Slip Opinion at 15.

<sup>22</sup>*Id.*

<sup>23</sup>Slip Opinion at 20.

<sup>24</sup>See CFTC Part 30, 17 CFR 30

<sup>25</sup>See CME Rule 804.

<sup>26</sup>7 U.S.C.A. 6b

<sup>27</sup>7 U.S.C.A. 6c(a)(5) (emphasis added). This section of the CEA includes the reference to “spoofing.” The Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. No. 111-03, H.R. 4173 (July 21, 2010) (“Dodd-Frank

Act”).

<sup>28</sup>7 U.S.C.A. 25(a)(1)(D)

<sup>29</sup>See 7 U.S.C.A. 9(c)(1). See also *CFTC v. Monex Credit Company et al.*, Case No. SACV 17-01868 JVS (DFMx), Central Dist. of Cal, May 1, 2018

<sup>30</sup>See Note 4, *supra*

